Filing Season Finds: Valeant Pharmaceuticals (VRX)

Valeant Pharmaceuticals (VRX: $12/share) was one of the 700 10-K's we processed last week. Analyst Cody Fincher made a total of 44 adjustments to Valeant's financial statements with a total value of $50 billion. The adjustments were applied as follows:

- 21 income statement adjustments with a total value of $4 billion
- 16 balance sheet adjustments with a total value of $11 billion
- 7 valuation adjustments with a total value of $35 billion

We first raised red flags about Valeant in 2014 when the stock was trading at ~$120/share. Today, with the stock at 1/10th of that price, we still see many reasons for investors to steer clear. Here are our four largest takeaways from Valeant's 10-K.

Unusual Goodwill Impairment

One of the largest single adjustments we made was reversing a $1.1 billion write-down Valeant took for the underperformance of some of its acquisitions. We eliminated this non-operating expense from net operating profit after tax (NOPAT) while adding back the after-tax value to invested capital to hold the company accountable for its capital allocation decisions.

This goodwill impairment was plainly disclosed on the income statement, but we did find an interesting detail on page 55 in the footnotes. Valeant assessed the value of its goodwill over the course of Q3 and Q4. During Q4, the company decided they had taken too large an impairment in the previous quarter and essentially took a "write-up" of $39 million for the fourth quarter. This practice is allowed under accounting standards, but it is certainly unorthodox and helped Valeant report better than expected earnings in 4Q16.

Pricing Issues Take Their Toll

It's no secret that pricing pressure hurt Valeant's bottom line in 2016. Thanks to a footnote on page 48 of their 10-K, we now know just how big that impact was: $652 million. Lower prices had a bigger impact than volume issues, which lowered contribution profit by $531.

Falling prices compressed Valeant's NOPAT margin from 18% to 11% and caused its return on invested capital (ROIC) to fall from 5% to 2%. Currently, Valeant is not generating enough NOPAT to cover the interest payments on its debt, which means we can expect to see further asset sales in the future.

Rising Customer Concentration

Analysis of Valeant's pricing problems has focused on political pressures. However, an item we found on page 180 suggests there could be some structural problems facing the company in particular. The percentage of Valeant's revenue from its top three customers rose from 36% in 2014 to 49% last year. As Valeant becomes more reliant on a few large customers, it may be losing pricing power.

Falling Stock Could Hurt Employee Retention

Valeant disclosed its employee stock option activity on page 154. The company revealed that it has 4.1 million outstanding stock options with a weighted average exercise price of $49.57/share. Essentially, VRX could quadruple and many employees would still be sitting on worthless options. Even the options Valeant granted just last year have a weighted average exercise price of $25.60/share, more than double the current stock price.

Valeant doesn't rely on stock compensation as much as some other companies, but you have to wonder if the low stock price will hurt its ability to retain key employees. Vesting stock options are usually a good incentive for employees to stick around, but if those options are worthless, employees might be more likely to jump ship.

This article originally published here on March 9, 2017.

Disclosure: David Trainer, Cody Fincher, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

Follow us on Twitter (#filingseasonfinds), Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensic accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?
ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.